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MICHAEL RODAK, J

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1518

WILLIAM H. GORDON and FERN GORDON, his wife,
Petitioners,

vs.

duPONT GLORE FORGAN, INCORPORATED,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

WHETHER THE INADVERTENT FAILURE OF A STOCKBROKER TO PROMPTLY ADVISE ITS CUSTOMER THAT THE EQUITY IN THAT CUSTOMER'S MARGIN ACCOUNT HAS FALLEN BELOW THE MAINTENANCE LEVEL PRESCRIBED BY THE NEW YORK STOCK EXCHANGE CREATES A CAUSE OF ACTION UNDER THE SECURITIES EXCHANGE ACT OF 1934 IN FAVOR OF THAT CUSTOMER WHERE THE CUSTOMER KNOWS OF THE UNDERMARGINED CONDITION OF HIS ACCOUNT, MAINTAINS HIS SILENCE FOR A SUBSTANTIAL PERIOD OF TIME AND FAILS TO TAKE CORRECTIVE ACTION.

ARGUMENT

Declining to express an opinion "beyond the narrow holding of this case", the appellate court below *held* that "under Rules 431 and 432 [of the New York Stock Exchange] there is no right of action that will allow a recovery to investors who know their accounts are inadvertently undermargined, maintain their silence for a substantial period of time, and take no corrective action." (Pet. App. 11). Contrary to the suggestion of the Petitioners, neither the Court of Appeals for the Second Circuit nor the Court of Appeals for the Seventh Circuit has held otherwise. Contrary to the contention of the Petitioners, no clear conflict of legal principles has been created by the appellate court below. In the appellate court's own

words, it refused "to synthesize" the Seventh and Second Circuit cases discussed below (Pet. App. 10), a synthesis in no way dictated by the holdings in either of those circuits.

Nonactionability of Inadvertent Exchange Rule Violation

No federal court of appeals in any circuit has held that an inadvertent violation by a stockbroker of a stock exchange rule is actionable under the Securities Exchange Act of 1934. The Seventh Circuit requires additional facts that are "tantamount to fraud" in connection with an exchange or dealer association rule violation in order to support a private action. *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 143 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969). In fact, in *Buttrey*, cited by the Petitioners as in conflict with the decision of the appellate court below, the Court of Appeals stated that "mere errors of judgment might not support a federal cause of action" and it refused to decide whether an alleged violation of Rule 405 is *per se* actionable. 410 F.2d at 142, 143.

The two other Seventh Circuit cases cited by the Petitioners are consistent with the *Buttrey* holding requiring fraud in connection with an exchange or dealer association rule violation for a cause of action under the Securities Exchange Act. In *Securities and Exchange Commission v. First Securities Company of Chicago*, 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972), the court determined liability on the basis of fraudulent conduct on the part of the president of the securities firm in question. In *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970), the court

held that the dismissal of a claim for violation of a dealer association rule for failure to state a cause of action under §15A of the Securities Exchange Act was not reversible error because the "same theory" was incorporated in a separate count alleging securities *fraud*.

The Second Circuit Court of Appeals did *not* hold in *Colonial Realty Corporation v. Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966), as Petitioners erroneously contend (Pet. p. 9), that a private right of action under the Securities Exchange Act arises in the case of a violation of a "specific" exchange rule rather than a rule that states "a vague general admonition". To the contrary, the court held that a violation of the "fair practice" rules of the New York Stock Exchange and the National Association of Securities Dealers was not actionable under that Act.

Judge Friendly's opinion in *Colonial Realty* offers a method for determining on a rule-by-rule basis whether federal civil liability is to be imputed for violation of a given exchange rule. Central to this analysis is the "nature of the particular rule and its place in the regulatory scheme". 358 F.2d at 182. Rule 431 of the New York Stock Exchange, concerning *maintenance* margin requirements as distinguished from *initial* margin requirements, was not adopted by the Exchange pursuant to a statutory or regulatory command, but reflects an exercise of discretion by the Exchange expressly conferred by Regulation T, §7(e), 12 C.F.R. §220.7(e). (Respon. App. 1). Judge Friendly's analysis does not indicate that the force of law should be afforded to such a discretionary rule.

"Pari Delicto": Maintenance as Distinguished from Initial Margin Requirements

Regarding the defense of *pari delicto*, the appellate court below did not refuse to follow the decision of the Second Circuit in *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971), rather it declined to extend the holding in that case to the operatively different facts before it because of "the inequitable results that can flow from such an approach". (Pet. App. 10).

Pearlstein involved the violation by a stockbroker of a federal regulation with the force of law, *i.e.*, Federal Reserve Board Regulation T, 12 C.F.R. §220, promulgated pursuant to §7 of the Securities Exchange Act of 1934, 15 U.S.C. §78g. The appellate court below, on the other hand, considered the violation of a rule of the New York Stock Exchange that has never been held to have the force of law.

The federal regulation in *Pearlstein* provides an *initial* margin requirement that controls the amount of credit that may be extended by a brokerage firm to a customer in connection with the purchase of a security. The exchange rule in question, on the other hand, provides a substantially lower *maintenance* margin requirement that controls the amount of equity that must be maintained in a customer's margin account subsequent to the purchase of a security for that account in order to secure the credit that has already been extended to that customer. This is a distinction with an important difference. For, the protection of "the economy as a whole" from "excessive speculation" motivated in part the *Pearlstein* court when it

ruled that *pari delicto* is not a defense in an action arising from the violation of Federal Reserve Board initial margin requirements. 429 F.2d at 1140. No such national interest is involved once the credit has been properly extended, as here, and only the question of the maintenance of the customer's equity remains.

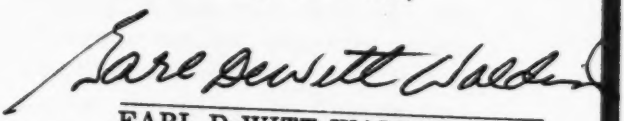
No Confusion in the Market Place

The Petitioners' prophesy of a drastic shift of securities transactions from one federal forum to another as a result of the decision below is grossly speculative. Only a market place that fails to take into account the difference between fraud and inadvertence, the difference between a federal regulation and an exchange rule, and the difference between an initial margin requirement and a maintenance margin requirement, would be confused by the decision of the appellate court below and those decisions discussed above issued in the Seventh and Second Circuits. No such market place exists. No such confusion exists.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be denied.

Respectfully submitted,



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APPENDIX

Federal Reserve Board Regulation T, §7(e), 12 C.F.R. §220.7(e) (1973), provides:

"*Additional requirements by exchanges and creditors.* Nothing in this part shall (1) prevent any exchange or national securities association from adopting and enforcing any rule or regulation further restricting the time or manner in which its members must obtain initial or additional margin in customer's accounts because of transactions effected in such accounts, or requiring such members to secure or maintain higher margins, or further restricting the amount of credit which may be extended or maintained by them or (2) modify or restrict the right of any creditor to require additional security for the maintenance of any credit, to refuse to extend credit, or to sell any securities or property held as collateral for any loan or credit extended by him."

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that three copies of this, the Respondent's Brief in Opposition, were mailed to Richard B. Marx, Esq., Counsel for Petitioners, Marx and Squitero, Suite 7A, 2951 South Bayshore Drive, Miami, Florida, this 16 day of May, 1974, and that all parties required to be served have been served.

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